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MCDC Initiative For Conduit Borrowers

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Topics to be Covered

- SEC's increased enforcement efforts regarding continuing disclosure and the SEC's Municipalities Continuing Disclosure Cooperation (MCDC) Initiative

- During this session, our speakers will:
  - Provide an overview of the MCDC Initiative
  - Suggest approaches to decision making and responding to the Initiative for conduit borrowers
  - Discuss the need for effective procedures to monitor compliance with continuing disclosure in the future and suggest possible policies and procedures

- To ask a question:
  - Click the chat icon/bubble on the top right of your screen
  - Type in your question and hit send
  - Questions will be addressed at the end of the presentation

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MCDC Initiative – a Recap

On March 10, 2014, the SEC's Enforcement Division introduced an initiative to encourage self-reporting:

- By municipal securities issuers, obligated persons, and underwriters of possible securities law violations
- Related to misrepresentations in offering documents concerning an issuer's prior compliance with its continuing disclosure obligations

The Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative) is the latest SEC effort in a long campaign to require timely, accurate, and uniform secondary market information from municipal securities issuers

- Past efforts include indirect regulation through municipal securities underwriters, press campaigns, seeking additional regulatory authority from Congress, increased market transparency, and enforcement actions

MCDC Initiative – a Recap

Before 2013, despite reports of widespread issuer noncompliance with at least some continuing disclosure obligations, the SEC had not brought a related enforcement action against an issuer or emphasized SEC Rule 15c2-12 in its enforcement actions against underwriters

MCDC Initiative – a Recap

In July 2013, the SEC set a groundbreaking precedent by undertaking enforcement actions against Indiana's West Clark Community Schools and the school district's underwriter based on statements in offering documents that the school district was compliant with its previous continuing disclosure agreement

- The school district hadn't submitted any of the required annual financials or event notices
- The SEC alleged that the underwriter's due diligence efforts were inadequate as it failed to discover that the school district was not compliant with its prior continuing disclosure obligations

MCDC Initiative – a Recap

Under the Municipalities Continuing Disclosure Cooperation Initiative (MCDC Initiative), the Enforcement Division will recommend "favorable settlement terms" upon self-reporting of such possible violations

For eligible self-reporters, the Enforcement Division will recommend:

- Settlement through cease-and-desist proceedings that do not require an admission of liability
- Not levying a financial penalty against issuers
- Tiered financial penalties against underwriters
    - Penalties will range from $20,000 to $500,000, depending on the size and number of offerings reported

MCDC Initiative – a Recap

Recommended remedial actions for Obligated Persons:

- Establishing compliance policies and procedures
- Complying with prior and existing continuing disclosure obligations
- Cooperating with subsequent SEC investigations
- Disclosing the terms of the settlement in its official statement for five years
- Providing a compliance certificate to the SEC regarding the above actions one year from the date on which the cease-and-desist proceeding is instituted

MCDC Initiative – a Recap

Underwriters' recommended remedial actions:

- Retaining an independent consultant to undertake a compliance review and provide recommendations regarding the underwriter's due diligence process and procedures
- Implementing the consultant's recommendations
- Cooperating with subsequent SEC investigations
- Providing a compliance certificate to the SEC regarding the above actions one year from the date on which the cease-and-desist proceeding is instituted

MCDC Initiative – a Recap

Individuals **may not** self-report through the MCDC Initiative

The SEC's Enforcement Division will determine whether municipal officials and underwriting firm employees should be the subject of an SEC enforcement action on a **case-by-case** basis, considering such factors as the individual's level of intent and cooperation with the SEC

The Enforcement Division indicates that the remedies it seeks will be more severe for eligible issuers and underwriters who fail to self-report through the MCDC Initiative

The Division states that it will likely recommend financial penalties for such non-reporting issuers and financial penalties higher than those set forth in the MCDC Initiative for such non-reporting underwriters

MCDC Initiative – Penalties

Penalties: Administrative Proceedings

- Cease-and-desist order
- Monetary Fines

Penalties: Civil Actions

- Injunctions
- Monetary Fines

MCDC Initiative – What it Does Not Cover

<u>Covers Only CDA Noncompliance</u>

- Other Misrepresentations Not Covered
- Individuals Not Covered
- Officials of Issuers, and Underwriter Employees and Supervisors Not Covered
- Individuals Must Be Identified

<u>Referrals to Other Agencies (FINRA, DOJ, state regulators) May Occur</u>

MCDC Initiative – Reporting Deadlines

- **The deadline for underwriters to self-report was on September 10, 2014**
- **The deadline for Obligated Persons was extended to December 1, 2014**

MCDC Initiative – A Basic Approach to Evaluating Exposure

1. Compile a listing of bonds issued within the last five years—this is the 'universe' that must be tested for false or misleading statements vis a vis prior disclosure undertakings
   - What did the offering documents say (or not say) about prior disclosure compliance?
   - Were any statements materially misleading (e.g., West Clark Community Schools statement below)?

Compliance with Previous Undertakings

In the previous five years, the School Corporation has never failed to comply, in all material respects, with any previous undertakings in a written contract or agreement that it entered into pursuant to subsection (b)(5) of the Rule.

Note: If no bonds were issued within the last five years, MCDC is not relevant. However, now is a good time to review or establish formal policies and procedures related to ongoing disclosure obligations and remedy any prior lapses in compliance. More on that in later slides…

MCDC Initiative – A Basic Approach to Evaluating Exposure

2. Research prior compliance for all relevant issues of the Obligated Person. The scope of the review should include all issues outstanding during the five years leading up to the date of the offering document(s). Depending on circumstances, the review may need to go back as far as ten years.

- Prior to July 1, 2009, filings were posted with the NRMSIRs
  - Bloomberg L.P.
  - DPC Data
  - Interactive Data Pricing and Reference Data
  - Standard & Poor's
- On or after July 1, 2009, all filings posted to EMMA
- Is it safe to assume that use of a dissemination agent means everything is okay? Not necessarily…
  - Most DA's simply post, but do not actually review content for completeness.
  - Posting errors happen

MCDC Initiative – A Basic Approach to Evaluating Exposure

3. For each relevant bond issue, compare the requirements stated in the Continuing Disclosure Agreement (CDA) to what was actually posted to the NRMSIRs and EMMA

   - There may be different requirements for different issues.
   - Were all required filings made? Were they made on time? Did the content of each filing meet the requirements listed in the CDAs?
   - Material Event disclosures are difficult to evaluate:
     - If a tree falls in the woods…
     - What is timely? For bonds issued after December 1, 2010, timely is defined as within 10 business days of the event. However, for bonds issued prior to that date the requirement was more ambiguously defined as "in a timely manner".
     - Pay particularly close attention to ratings changes and other events that are easily verifiable through data mining.

MCDC Initiative – A Basic Approach to Evaluating Exposure

4. Find out what, if anything, was reported by your underwriter(s).
   - Underwriters were incented to report more vs. less, and their deadline has passed
   - Materiality is subjective, so you may not agree!
5. Review findings with legal counsel familiar with SEC rules and enforcement
   - Are discovered lapses material?
   - Does self-reporting create exposure elsewhere?
   - How does the underwriter's self-reporting affect your decision?
   - What if the underwriter did *not* report, but you found lapses?

MCDC Initiative – Additional Considerations

- Initiative extends only misrepresentations concerning CDA compliance
- Individuals may not self-report through the MCDC Initiative
  - The SEC's Enforcement Division will determine whether municipal officials and underwriting firm employees should be the subject of an SEC enforcement action on a case-by-case basis, considering such factors as the individual's level of intent and cooperation with the SEC
- The Enforcement Division indicates that the remedies it seeks will be more severe for eligible issuers and underwriters who fail to self-report through the MCDC Initiative
- The Enforcement Division states that it will likely recommend financial penalties for such non-reporting issuers and financial penalties higher than those set forth in the MCDC Initiative for such non-reporting underwriters

Materiality and Self-Reporting

- Determining materiality is obviously central to making a decision to self report:
  - Has there been a misstatement (which involves a determination of compliance by an issuer in all material respects)?
  - If there was a misstatement, was that material?
- Determinations relating to disclosure are not the same making a determination to self-report
- Compliance with the MCDC Initiative is voluntary

MCDC Initiative – Whether To Self-Report: Materiality

<u>The Well-Established Standards</u>:

- To violate Rule 10b–5, a statement or omission must be "misleading as to a material fact."
- For the purposes of Rule 10b-5, a fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."
- Omitted information is considered material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."

MCDC Initiative – Whether To Self-Report: Materiality

Factors to be considered include (but are not limited to):

- Importance of the information to be provided
- The extent to which information was available in other places
- Length of delay for late filings
- The reason for the failure
- Is there a pattern of failures
- When did the failures occur
- Are there now policies and procedures in place

Whether to Self Report?

- Whether to self-report is based on a variety of factors:
  - Have any underwriters already made a filing?
  - What has the issuer said about continuing disclosure in recent official statements?
  - Is the issuer already subject to an enforcement proceeding?
  - Is the issuer prepared for the consequences of filing?
    - Cooperating with subsequent investigations
    - Disclosure of settlement terms
    - Establishing policies and procedures
    - Publicity
    - Issuer officials
  - Can the SEC prove its case?

MCDC Initiative –Considerations of Self-Reporting or Not

What is involved in an enforcement action?

- How does the normal process differ from the MCDC initiative?
- Will there be an opportunity to discuss the self-reporting with the SEC?

Conflicts

- Is the issuer official making any such determination also the issuer official who would be named in the Questionnaire submitted to the SEC?
- Is the issuer official who is considering self-reporting prepared to bring that decision to the appropriate approving officials or elected body of the issuer, if necessary or appropriate, and to explain the recommendation?
- Is it okay to use counsel who was involved in the original transaction where the misstatement was made?

MCDC Initiative – Additional Considerations of Interest for Reporting

Items to further consider when determining whether to self-report:

- There is a five year statute of limitations for the SEC seeking financial penalties. An MCDC filing is not an agreement to toll the statute of limitations, which continues to run after such filing, absent execution of a tolling agreement by the issuer. It appears that there is no statute of limitations for SEC enforcement actions seeking injunctive or equitable relief.

- The filing of an MCDC self-report by an issuer should not in and of itself be treated by SEC staff as an offer of settlement or an admission of liability.

- If an issuer does not participate in MCDC but submits a separate writing to SEC staff regarding a potential violation, the issuer will not be entitled to the benefit of the MCDC settlement terms.

MCDC Initiative – Next Steps

- Whether you are going to report or not, first conduct an audit of your historical compliance
- If you do find a misrepresentation, consult with counsel to determine materiality
- If there is a potential material misrepresentation, analyze possible consequences of self-reporting with counsel
- Determine what level of approval is needed to make a determination about whether or not to file
- If applicable, submit a questionnaire and have your counsel enter into discussions with the SEC to follow up
- Even if you do not report, now the time to review or implement formal policies and procedures for continuing disclosure…

Key Ingredients to Effective Procedures

1. Identify the key parties involved in the disclosure
   - Who is the "Process Owner"?
   - Who will provide the information that goes into the filings? (e.g., Accounting & Finance staff, Operational staff)
   - Who prepares the filing package? Who reviews? Who posts to EMMA?
   - What circumstances require input of legal counsel?
   - What roles are performed by third party disclosure consultants or dissemination agents?

2. Formally document the workflow and associated tasks related to disclosure for:
   - New issues (primary disclosure)
   - Required Annual Filings
   - Material Events
   - Voluntary disclosure
   - Ongoing training

3. Embed appropriate internal controls throughout the process

Additional "Helpful Hints"

1. Maintain a "Debt Inventory" that lists bonds with disclosure obligations and those that do not (e.g., private placements, met an exemption, etc.)
2. Reconcile CDA requirements for new issues against existing requirements
3. Leverage technology and "office tools" to ensure both timely and effective disclosure compliance
   - Setup "ticklers" through EMMA, shared office calendar (e.g., the "close calendar"), or existing CMS
   - Automate workflows
   - Subscribe to ratings agency alerts regarding ratings events

Example of a "Debt Inventory"

Bonds Subject to Rule 15c2-12

Bond Series	Issue Date	Original Par Amount	Maturity Date	CUSIP	Principal Outstanding	Date Retired	Rated By	Credit Provider	Next Annual Disclosure Filing Due Date
2000A	7/1/2000	10,000,000	7/1/2035	123456AC3	10,000,000		Fitch and S&P	AMBAC	12/31/2015
2000B	7/1/2000	2,500,000	7/1/2025	123456AD1	2,500,000		Fitch and S&P	AMBAC	12/31/2015
2000C	7/1/2000	4,000,000	7/1/2030	123456AE9	4,000,000		Fitch and S&P	AMBAC	12/31/2015
2003-1	6/1/2003	20,000,000	1/1/2033	123456AT7	20,000,000		S&P and Moody's	AMBAC	12/27/2015
2003-2	6/1/2003	5,000,000	1/1/2018	123456AU4	5,000,000		S&P and Moody's	AMBAC	12/27/2015
2004B	6/1/2004	10,000,000	1/1/2039	123456AZ2	10,000,000		S&P	AMBAC	12/27/2015
2007B	9/1/2007	2,500,000	1/1/2017	123456BJ7	2,500,000		Moody's	N/A	3/2/2015
2007C	9/1/2007	2,500,000	1/1/2022	123456BK4	2,500,000		Moody's	N/A	3/2/2015
2007D	9/1/2007	5,000,000	1/1/2027	123456BL2	5,000,000		Moody's	N/A	3/2/2015
2004A	6/1/2004	4,000,000	1/1/2039	123456AY5	-	1/1/2014	S&P	AMBAC	N/A - bonds retired
2007A	9/1/2007	2,500,000	1/1/2012	123456BH1	-	1/1/2012	S&P	N/A	N/A - bonds retired

Bonds Exempt from Rule 15c2-12

Bond Series	Issue Date	Par Amount	Maturity Date	CUSIP	Principal Outstanding	Date Retired	Rated By	Credit Provider	Reason for Exemption
2001A	8/23/2001	35,000,000	7/1/2012	123456AK5	35,000,000		Fitch and S&P	N/A	VRDO w/ $100k denominations
2001B	8/23/2001	23,700,000	7/1/2036	123456AM1	23,700,000		Fitch and S&P	N/A	VRDO w/ $100k denominations

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Example of a CDA Summary

Operating Data Required for Outstanding Debt (in addition to audited financials)					
as defined in Official Statements (typically Appendix B)					
Table Name or Section Header	**Source**	2000ABC	2003-1&2	2004B	2007BCD
Faculty and Staff Statistics	HR Dept				x
# of Full-time and Part-time students from fall semesters	Registrar's Office	x	x	x	x
Credit Hours from Fall Semesters	Registrar's Office				x
Enrollment Profile for All Campuses	Registrar's Office	x	x	x	x
Admissions & Enrollment Information for Freshman	Admission's Office				x
Summary of Fees and Charges	Finance Dept	x	x	x	x
Market Value of University's Endowment	Finance Dept	x	x	x	x
Gifts, Grants and Bequests for Past Five Years	Finance Dept	x	x	x	x
Summary of Financial Aid Awarded	Financial Aid Dept	x	x	x	x
Filing Deadline		6 months from FYE	180 Days from FYE	180 Days from FYE	245 Days from FYE
If audited financials are unavailable at filing due date, unaudited financials should be posted by the normal deadline.					

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Q & A

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